



Solidarity House

8000 EAST JEFFERSON AVE
DETROIT, MICHIGAN 48214
PHONE (313) 926-5000
FAX (313) 823-6016

INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA – UAW

RON GETTELFINGER, *PRESIDENT*

ELIZABETH BUNN, *SECRETARY-TREASURER*

VICE-PRESIDENTS: GENERAL HOLIEFIELD • BOB KING • CAL RAPSON • JIMMY SETTLES • TERRY THURMAN

February 18, 2009

TO: Members of the House Judiciary Committee

FROM: Nadine Nosal, Legislative Coordinator, UAW Michigan CAP
Jim Shake, Senior Actuarial Consultant, UAW Social Security Dept.

SUBJECT: Public Employee/Retiree Health Care Bill Package – House Bills No. 4071
– 4079

The International Union, UAW represents over 400,000 active and retired members across Michigan in both the private and public sectors. The bills before you today will have a major impact on thousands of members and retirees we represent in the public sector. UAW has members in state and municipal government as well as members in the public school system and community colleges.

UAW supports House Bill No. 4076 which will increase the number of retiree representatives on the State Retirement Board. We are neutral on House Bills No. 4071, 4074, 4078 and 4079. We do, however, have concerns with House Bills No. 4072, 4073, 4075 and 4077 which are addressed in the attached comments by Mr. Shake.

These bills are very important to our members, your constituents, and we ask that you not rush them through this committee process without a thorough understanding of their ultimate impact on employee/retiree health care benefits.

Thank you.

Attachments
NN eek
opeiu494afl-cio

MI Proposed Bills # 4073/4075/4077

Summary of Issues – 2/13/2009

We were told last session that specific language in Bill 4075 pertaining to the funding of benefits not being a contractual obligation would be removed. That language was not removed, and the modifying language that was added is also very troubling. The added language would limit the benefits provided to what assets are available in the trust. Given the current economic climate, it would be all too easy to delay the funding of benefits that have already been contractually promised through the collective bargaining process.

Any time benefits are pre-funded, responsible investment policy and oversight is critical - especially when public funds are involved. The investment policy and oversight language in the proposed MI bills is deficient in this regard. One specific example in bill 4073 absolves the trustees of responsibility for maintaining the adequacy of the trust to meet obligations and enforce payment of contributions, but does NOT appear to assign that responsibility to anyone else.

The percentage of pre-funding determines what discount rate can be used in the actuarial valuation. Limited pre-funding would preclude any noticeable savings to liability or expense (according to commonly accepted actuarial guidance).

There is at least one provision that could be interpreted as favoring employers in the collective bargaining process.

There needs to be strong guarantees that any pre-funded money cannot be later transferred to other funds, such as happened in 2002 or 2003 under then-Gov. Engler, or otherwise diverted before going into the 115 trust.

In general, the use of the term premium in the bills may be misleading, since self-insured plans pay actual costs plus administrative expenses. A so-called premium equivalent could be overstated up front to anticipate adverse experience in the future which might not come to pass. This would cause any retiree contributions to also be overstated.

The bills do not address how any Medicare Part D premium rebate, or insurer rebates, would be treated. These rebates should be used to reduce retiree health care costs, rather than applied to other parts of the state budget.

Attached are specific comments about provisions in the above bills. We have also included comments and improved language on the related trust bills numbered 4072 and 4078.

MI Bills # 4073/4075/4077, and related bills

Issues/Areas of concern are as follows:

- 1. Elimination of Full Rights to Benefits**
 - Allowing benefits to be restricted to available assets (if any)
 - We were told this language would be eliminated, but it was not
- 2. No Promise of Any Pre-funding**
 - Gives municipalities the authority they want without promising any real funding
 - Level of Pre-funding affects expense and liability
- 3. Lack of Fiduciary responsibility and investment policy/management controls**
 - See details below
- 4. Vague and Inadequate Definitions of Important Terms**
 - Lack of qualifications of actuaries engaged to value expense/liabilities (Bill 4078)
 - Vague terms concerning actuarial liabilities
 - Actuarial Studies vs. formal valuations (Bill 4078)

SPECIFIC BILLS

Bill # 4073

Comments/Questions

- 1. Elimination of Full Rights/No Promise of Prefunding (Issues #1/2)**

Section 17 - Pages 11-12 – lines 5-6 on page 12 limit the amount of benefits provided to the amount of assets in the trust fund. This impermissibly restricts benefits that have been collectively bargained to whatever assets are in the trust, and subjects benefits to outside influences affecting the decision to fund benefits by the municipality. There is no mention of any obligation of the municipality to fund benefits to the contractual level, and paragraph (9) of Bill 4075 restricts the issuance of securities to 75% of the liability.

Further, the level of pre-funding affects the extent of savings in liability and expense compared to an unfunded arrangement. Common actuarial guidance would state that if a municipality only funded half of the GAS 45 expense for the year, then the municipality would need to lower the discount rate used for valuing liability and expense, increasing liability and expense. If no pre-funding of the

expense was made, then there would be no savings. (See attached exhibits)

2. Lack of Fiduciary Responsibility (Issue #3)
Section 3 paragraph (4) page 5 – Given that medical expenses in retirement vary widely year to year as compared to fixed pension benefits, how appropriate is it to have the exact same investment restrictions as for the pension fund?
3. Lack of Fiduciary Responsibility/Vague Terms (Issues #3/4)
Section 3 paragraph (5) page 6 –
 - a. The term “annual obligations of the trust” definition seems too vague.
 - b. Administrative and Investment Fee Structure – This appears to allow for a (potentially generous) fixed fee/payment schedule, even if actual expenses are less than the schedule. There needs to be greater protection against possible abuse.
4. Elimination of Full Rights (Issue #1)
Section 3 paragraph (6) page 6 – although past members are granted contractual rights in the aggregate to the assets, there doesn't appear to be any language that grants past members benefits to which they are contractually entitled even in the absence of sufficient assets. (See comment 1 above) This needs to be rectified.
5. Elimination of Full Rights/Lack of Fiduciary Responsibility (Issues #1/3)
Section 8, pages 8-9 – Remaining assets – Why is there this reversion clause at all, when funds should be used exclusively for payment of benefits (and related expenses)? There could be a later move to fund retirement health benefits under a different arrangement temporarily, while transferring the remaining assets out of the trust.
6. Vague Terms (Issue #4)
Section 10 paragraph (2) page 9 – “prompt” crediting of contributions. This term needs to be more clearly defined (similar to crediting of 401(k) employee deferrals) so that a specific time range (e.g. within 15 business days) is included.
7. Lack of Fiduciary Responsibility (Issue #3)
Section 15 paragraph (1), subparagraphs (b) and (c) page 11 – WHY should the trustees NOT be responsible for the adequacy of the trust to meet/discharge obligations or to enforce the payment of contributions/appropriations? There is no language in this bill clarifying who would be responsible. If they intended to assign that responsibility to either the state treasurer or the governing board(s) of the retirement systems, this needs to be explicitly spelled out in the legislation.
8. Vague Terms (Issue #4)
Pages 11-12 – There appears to be no Section 16. It jumps from Section 15 to Section 17. Was this a simple numbering error, or is there a Section 16 that was excluded from the version we received as of February 12, 2009?

Bill # 4075

This bill appears to provide a municipality with the ability to issue debt securities to fund the (GASB 45) unfunded accrued liability without having to put it to a vote by its residents. There are notice and petition requirements, however. (In other states, the debt is referred to as OPEB obligation bonds.) There are some troubling or conflicting provisions in the bill as described below:

1. Elimination of Full Rights/No Promise of Pre-funding (Issues #1/2)
Section 518 paragraph (1). Pages 1-2 – lines 3-4 on page 2 limit the amount of benefits provided to the amount of assets in the trust fund. This impermissibly restricts benefits that have been collectively bargained to whatever assets are in the trust, and subjects benefits to outside influences affecting the decision to fund benefits by the municipality. There is no mention of any obligation of the municipality to fund benefits to the contractual level, and paragraph (9) of this Bill (4075) restricts the issuance of securities to 75% of the liability.
2. Vague Terms (Issue #4)
Section 518 paragraph (1) – Page 1 line 5 – the language pertaining to the “unfunded accrued liability” should be amended to read “unfunded accrued liability as determined by the plan’s actuary”
3. No Promise of Pre-funding/Vague Terms (Issues #2/4)
Section 518 Paragraph (5), page 3, lines 8-25 - there is a possible conflict between sub-paragraph (A) (lines 12-14) and the 75% limit stated in paragraph (9), page 4, lines 11-16. Do these provisions, when taken together, mean that only 75% of the unfunded liability can be provided for under debt issued by the municipality? That would mean that current revenues would be needed to provide the balance. Why does the 75% provision exist, when it could be more advantageous to cover the full obligation if existing debt levels for the municipality are lower?
4. Elimination of Full Rights (Issue #1)
Sub-paragraph (E) – page 3, lines 22-23 regarding having a plan in place to mitigate the increase in health care costs - may give an employer undue leverage to pressure employees to change or reduce health benefits.
5. Vague Terms (Issue #4)
Section 518 Paragraph (11), page 4, lines 22-27 – mandates that the assumed asset rate of return for a funded GAS 45 arrangement be at least 100 basis points higher than the interest rate being paid to the bond holders. What is the basis for this

provision? It seems arbitrary and demonstrates a very limited understanding of how the GAS 45 liabilities and expense are calculated. There is not a direct connection between the assumed rate of return and the bonding rate of interest.

Bill # 4077

Vague Terms (Issue #4)

This bill adds the definitions of “Health Care Trust Fund” and “Unfunded Accrued Liability” to Section 103 of MCL 141.2103.

Page 5, (new) paragraph (R), lines 6-9 - The definition of “Unfunded Accrued Liability” should be changed to substitute “Actuarial Valuation” for “Actuarial Study” and to substitute “Statement 43 or 45” for “Rule 43 or 45”. While substituting “Statement” for “Rule” merely conforms the bill language to the actual accounting terminology, substituting Actuarial Valuation for Actuarial Study is a substantial difference.

An actuarial Valuation is the formal valuation of the liability and expense for the plan that is relied upon for a municipality’s financial statements. An actuarial study can be any informal valuation that may use differing benefits, cost-sharing, or actuarial assumptions from what has or will be used for the formal accounting expense and liability for that municipality for any given year. Studies are often done to estimate liability and expense under varying hypothetical scenarios. It would be all too easy for a preliminary study to be relied upon (unintentionally or otherwise) in preparing a bond issue.

OTHER RELATED BILLS

Bill #4078

Vague Terms (Issue #4)

Section 205, page 1 line10 refers to employing the services of an actuary without requiring that the actuary be qualified by the actuarial profession to perform GAS 45 or other health care valuations.

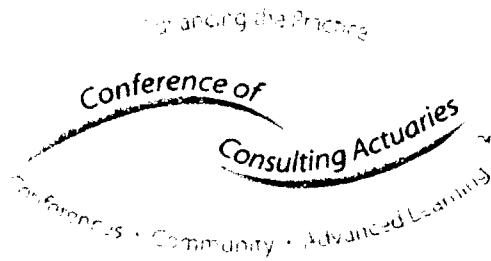
Many GAS 45 requests for proposals (RFPs), for example, require that at least one actuary be an Enrolled Actuary under ERISA (to cover the retirement forecasting portion of the valuation) and an actuary that is at least an ASA and a member of the Society of Actuaries' Health Section (to cover the health benefits pricing portion). Reference to actuaries should state that they should be qualified to perform those valuations under guidelines established by the American Academy of Actuaries.

Bill #4072

Vague Terms (Issue #4)

The bill appears to modify the authority for hospitalization, medical coverage, dental coverage, and vision coverage selection and plan administration. Prior to October 1, 2009, the benefit plans were jointly authorized (selected) by the Civil Service Commission and the Dep't. of Management and Budget, and paid by the Retirement Board. On and after October 1, 2009, the authorization is granted to the Civil Service Commission, the Retirement Board, and the Office of Retirement Services (in the Dep't. of Management and Budget - DMB). The plans are to be administered by the Dep't. of Management and Budget's Office of Retirement Services. The benefits will continue to be paid by the Retirement Board.

One question would be in regard to the make-up and level of authority/responsibility granted to the Office of Retirement Services. Also, the Civil Service Commission is now an autonomous entity within DMB, and has its administrative powers vested in the State Personnel Director. We do not know whether the prior protections provided by Civil Service have been changed at this point.



GASB 43/45 Part 2 Seminar

April 9-10, 2008

Co-sponsored by the American Academy of Actuaries and Society of Actuaries

All sessions of the Conference will be conducted in compliance with Federal and State antitrust laws and any discussion of anticompetitive activities among participants is strictly prohibited.

The views expressed here are those of the presenter(s), and not necessarily those of the Conference or its co-sponsoring organizations.

Copyright © 2008 Conference of Consulting Actuaries

All rights reserved by the Conference of Consulting Actuaries. Permission is granted to make limited copies of items for personal, internal, classroom or other instructional use, on the condition that the foregoing copyright notice is used to give reasonable notice of the Conference's copyright.

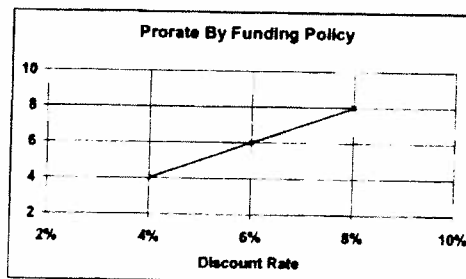
Valuation Discount Rate (For Partially Funded Plans)

One simple approach:

- Set the single discount rate part way between the lower rate for an Unfunded Plan and the higher rate for a Funded Plan
- Prorate based on where the Funding Policy falls between the PAYG amount and the ARC for a Funded Plan

Valuation Discount Rate (For Partially Funded Plans)

ARC (Funded)
Funding Policy
PAYG



Valuation Discount Rate (For Partially Funded Plans)

City of ABC Valuation as of October 1, 2004

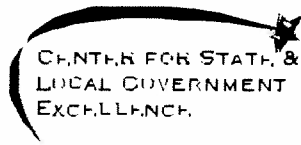
	Unfunded (PAYG)	Partially Funded	Funded
Funding Policy (As % of Pay)	10.2%	17.2%*	24.2%
Discount Rate	4%	6%*	8%
ARC (As % of Pay)	34.4%	27.9%	24.2%
UAAL	\$180 Mill	\$133 Mill	\$102 Mill

* Half way between PAYG and Funded

Valuation Discount Rate (For Partially Funded Plans)

This simple approach may understate the expense and liabilities:

- For plans that are mature or closed, or with lots of retirees, or have older average ages
- For plans whose Funding Policy vs. PAYG expense depletes the trust sooner
- For plans with a shorter duration



Issue Brief

The Crisis in State and Local Government Retiree Health Benefit Plans: Myths and Realities



July 2008



Is there a funding crisis in retiree health care? Although there are widespread reports of a major fiscal crisis, the reality is that some states face a fiscal crisis while others do not.

In analyzing actuarial reports, Dr. Robert Clark found that there is a "substantial variation in unfunded liabilities" depending on the size of the workforce, the generosity of the retiree health plan, the portion of the plan paid for by the state, and the type of employees in the plan.

Many state and local governments have begun to make changes in their health care plans to manage rapidly growing costs. This is important because "in 2006 the annual cost to state and local governments for retiree health plans averaged about 2 percent of employee salaries. If public sector employers continue to pay for these benefits on a pay-as-you-go basis, the cost of retiree health plans is projected to rise to 5 percent of payroll in 2050 (General Accounting Office, 2008)."

State and local governments can make changes to reduce that potential fiscal issue. The Center for State and Local Government Excellence and researchers from North Carolina State University's School of Public and International Affairs and College of Management have partnered to focus on state and local government retiree health care. Future Center publications will examine what governments are doing to finance retiree health care, policy alternatives, inter-generational issues, and benchmarking.

The Center for State and Local Government Excellence was founded to explore issues that are important to attract and retain the talent needed for public service. Offering high quality benefits will remain as important in the future as it has been in the past.

With heightened emphasis on the economic security of future retirees and increasing fiscal pressures, government leaders will need authoritative data to understand the issues.

The Center gratefully acknowledges the financial support from the ICMA Retirement Corporation to undertake this research project.

Elizabeth K. Kellar

Elizabeth K. Kellar
Executive Director
Center for State and Local Government Excellence

The Crisis in State and Local Government Retiree Health Benefit Plans: Myths and Realities

Robert L. Clark*

All states and many local governments provide health benefit programs for their retired employees.¹ These programs vary widely in their provisions, degree of government subsidy, the cost to the government, and the method of funding. Some states and localities require retirees to pay the full cost of participating in the health plan² while others offer health insurance that does not require any premium payment by the retiree. As a result of these differences, the annual cost of providing retiree health insurance varies substantially among public employers. The annual cost per retiree can range from a modest subsidy associated with allowing retirees to buy into the health plan for current employees to the full cost of medical insurance for retirees, which can exceed \$10,000. In a study that examined the Comprehensive Annual Financial Reports of the New England states, the Federal Reserve Bank of Boston (2007) found that annual benefit payments per eligible retiree in 2006 ranged from \$3,300 in Maine to \$11,000 in Connecticut.

Recently, retiree health plans in the public sector have become the target for closer scrutiny and concern because of their costs as well as the future unfunded liability of any benefit promises the government has made. The annual government expenditure on these plans has been increasing rapidly due to the general rise in medical costs and the increase in the number of retired public employees. Even as state and local leaders have struggled to find the funds to finance the annual cost of retiree health insurance, changes in accounting standards have shifted policy debates from the current cost of these programs to the long-term liabilities associated with the promise of health insurance in retirement to today's public employees. To some, the recently reported estimates of unfunded liabilities associated with retiree health benefit plans represent a fiscal crisis for many states and municipalities.

This Issue Brief explores some of the most important perceptions associated with retiree health plans and the new GASB accounting standards and assesses whether these beliefs are myths or realities. Sorting fact from fiction is central to determining optimum public policies and the likelihood that retiree health benefit plans will remain as an important component of the compensation for public sector employees.

GASB 45 and Accounting for Retiree Health

On June 21, 2004, the Government Accounting Standards Board approved Statement No. 45 (GASB 45). This statement requires public employers to produce an actuarial statement for retiree health benefit plans using generally accepted accounting standards as set forth by GASB.³ In general, GASB 45 requires states and local governments to report the present discounted value for the future liability of health care promises to current workers as these benefits are accrued, along with the present value of these promises to current retirees.⁴ In addition, the actuarial report must indicate the annual required contribution that is needed to pay current health care costs and to amortize current unfunded liabilities.

A common belief is that GASB 45 requires public sector employers to establish trust funds for their retiree health plans and to move toward full funding. This is a myth. The goal of GASB 45 is to provide a transparent assessment of the liabilities associated with health care promises to public employees. However, establishing a trust fund and contributing sufficient monies to cover current costs and accrued liabilities may be prudent public policy as it requires today's taxpayers to bear the full cost of today's public services.

This Issue Brief focuses on the current financial status of state retiree health plans and reports unfunded

*Robert L. Clark is a professor of economics and of management, innovation, and entrepreneurship in the College of Management, North Carolina State University.

actuarial accrued liabilities (UAAL), annual required contributions (ARC), and the current method of financing these plans. The unfunded liabilities (UAAL) are the difference between all actuarial accrued liabilities (AAL) and any assets the employer has set aside in an irrevocable trust. Obviously, if the plan is completely pay-as-you-go, the unfunded liabilities are equal to the accrued liabilities because there are no assets held by the employer with which to pay for the future health insurance of today's employees. The unfunded liabilities of many states and local governments are large in absolute value and relative to total state expenditures, debt, and state per capita income.

Annual required contributions are how much the employer must contribute to cover this year's cost of providing health insurance to current retirees, plus the amount needed to amortize the existing unfunded liability over a 30-year period. In general, annual required contributions will exceed the annual pay-as-you-go cost by the amortization of the unfunded liability over 30 years. Thus, if a government were to establish a trust fund for its retiree health benefit plan and contribute monies each year equivalent to the ARC, the state or locality would be on pace to fully fund the plan. Obviously, this level of financing will exceed the pay-as-you-go cost of these programs in the short run, but it will reduce the new funds needed in future years as returns on the trust fund will help finance future payments.

ARCs and UAALs have been growing over time in most states and are now a major public policy issue. For example, in California, the annual cost to the state for retiree health and dental benefits more than tripled between 1998-99 and 2006-07 as the retiree health expenditure rose by an annual average rate of 17 percent, which was more than five times the rate of growth of state spending. The costs were expected to exceed \$1 billion in 2006-07. (Legislative Analyst's Office, California, 2006).

The present value of promised benefits based on current provisions of the health plans is determined by projecting the future age and service structure of the state labor force and retired state employees, and the cost of the health care promises made to these workers and retirees. The future liabilities are then discounted back to the date of the report. The actuarial accrued liabilities (AAL) represent the total cost associated with providing health insurance to current retirees and the expected cost of retiree health insurance earned to date by current employees.

In addition to the demographic projections, the actuarial consulting firm or in-house actuaries use two

key assumptions to calculate the UAAL and the ARC: the rate of medical inflation and the discount rate used to determine the present value of future retiree health benefits. Assumptions made by the actuary have a large impact on the projected discounted liabilities of retiree health plans. All actuarial statements project a rapid decline in the rate of medical inflation. Such declines are more likely to be wishful thinking or a myth. The rate of inflation for health care is uncertain and will depend on national health care policies. There is a common belief, which reflects current practice allowed by GASB 45, that funding reduces unfunded liabilities because trust funds prudently invested will yield higher returns than the risk-free discount rate used when there is no fund. This may be a myth as actual expenditures in future years are unchanged but using a higher discount rate lowers discounted liabilities. Whether this is a myth or reality is currently being debated by practicing actuaries and financial economists. In a forthcoming Issue Brief, we will discuss how these assumptions are made and their importance in determining the projected liabilities of retiree health benefit plans.

The AAL indicates the amount of money needed to pay all these future liabilities. Alternatively, this means that if the state or local government had a dedicated fund with assets equaling the AAL, then all currently accrued liabilities could be paid from the fund without any further contributions from the state. This is similar to having a fully funded pension plan or stating that the pension has a funding ratio of 100 percent.⁵ GASB 45 does not require that governments actually establish trust funds for these programs; however, several states have enacted trust fund legislation for their retiree medical plans as well as those of local entities in the state.⁶

GASB requires that the actuarial statements assume that the current provisions of the retiree health plan will remain in effect. There is a common belief that retiree benefits are protected by law and cannot be altered. This is a myth. Most states have been amending their health plans for active workers and retirees in response to rising health care costs. Changes include higher premiums, higher deductibles, higher co-payments, and more years of service to qualify for retiree health plans.⁷ The ability to modify retiree health plans provides states with some options to moderate their projected costs and thus reduce the UAAL and ARC presented in these actuarial statements.

GAO (2008) reports that all states have legal protections for their pension plans that limit the ability of a legislature to substantially alter the generosity of the

pension. The majority of states have constitutional provisions that describe how their retirement plans are to be "funded, protected, managed, or governed." However, retiree health plans are not accorded similar status. Reducing or eliminating retiree health benefits may be constrained by collective bargaining contracts but, in general, legislatures have more flexibility to reduce and modify retiree health benefit plans for public sector employees. If governments can significantly reduce benefits and thus liabilities, should these promises be considered liabilities at the same level as state and municipal bonds?

Is There a Funding Crisis?

Recent press reports spawned by GASB 45 statements and other assessments of the unfunded liabilities associated with retiree health have painted a picture of a major fiscal crisis. This is a reality in some states while in others it is simply a myth. There are substantial differences in the total liabilities of state retiree health plans, stemming from the generosity of the plan and the size of the public sector.⁸ To assess the reality of a funding crisis, we consider only the data reported in the actuarial statements that have been completed in response to the GASB requirements. Among the states whose actuarial reports we have examined, North Dakota (\$31 million), Wyoming (\$72 million), Iowa (\$0.2 billion), Oregon (\$0.3 billion), Rhode Island (\$0.5 billion), and Oklahoma (\$0.8 billion) have the lowest reported unfunded liabilities. In comparison, New Jersey (\$68.8 billion), New York (\$49.7 billion), California (\$47.9 billion), North Carolina (\$23.8 billion), Connecticut (\$21.7 billion), Louisiana (\$19.6 billion), and Texas (\$17.7 billion) have the highest UAALs.

The substantial variation in unfunded liabilities is a function of the size of the state workforce, the generosity of the retiree health plan, the portion of the total cost of the health program paid for by the state, and the type of employees included in the plan. For example, the retiree health plans of some states also include teachers and local government retirees while in other states only the retired employees of the state are included in the plan. In these states, teachers and local retirees may be included in other plans. Pew (2007) attempts to disentangle the cost differences based on the types of workers covered and reports its estimates of the UAAL associated with only state employees.

To better illustrate the magnitude of these liabilities and their importance to the various states, we examine the magnitude of the UAAL and ARC relative to

Table 1. UAAL and ARC as Percentage of Payroll

	UAAL as % of Payroll	ARC as % of Payroll
Alabama	229.6	17.6
Georgia	129.5	10.9
Hawaii	359.6	26.2
Maine	273.3	20.5
Maryland	351.1	26.9
Missouri	140.3	9.8
North Carolina	192.4	19.3
Oklahoma	30.0	3.2
Rhode Island	292.5	24.9
Texas	200.0	16.8
South Carolina	151.5	11.7
Virginia	15.3	1.2
Washington	67.9	5.7

Source: Actuarial statements prepared by the various states.

various important financial variables. Several of the actuarial statements indicate the UAAL and the ARC as a percent of payroll. Those ratios are reported in Table 1 for the states that included this information in their actuarial reports. The highest reported values for UAAL as a percent of payroll are found in Hawaii (359.6 percent), Maryland (351.1 percent), and Rhode Island (292.5 percent). The highest values for the ARC as a percent of payroll are Maryland (26.9 percent), Hawaii (26.2 percent), and Rhode Island (24.9 percent). These latter numbers are particularly impressive as they imply the proportion of state payroll needed to pay for current expenditures on retiree health care and the cost of amortizing the unfunded liability. Thus, to move toward a fully funded plan, these three states would have to allocate funds equal to one quarter of their annual cash payroll to finance the retiree health plan. These data indicate that for some states the annual cost and the unfunded liabilities associated with retiree health plans represent a major fiscal challenge.

We derive three additional measures of the relative size of the cost of retiree health benefit plans. First, we determine the implied per capita debt by dividing the UAAL by the state population for all of the states for which we have actuarial reports. These values are reported in column one of Table 2. Next, we report in columns two and three the UAAL and the ARC as a percent of the state budget. New Jersey has the highest per capita debt with a value of \$7,947, closely followed by

Table 2. Estimates of Per Capita Unfunded Liability and ARC as Percentage of Budget

State	Unfunded Liability Per Capita	UAAL as Percentage of Budget	ARC as Percentage of Budget
Alabama	\$2,760.15	59.58	4.58
California	\$1,330.91	22.82	1.71
Connecticut	\$6,224.02	107.41	7.87
Delaware	\$3,688.03	52.48	4.84
Florida	\$174.79	4.40	0.30
Georgia	\$1,646.95	44.37	3.73
Hawaii	\$7,652.37	115.39	8.39
Iowa	\$74.44	1.56	0.00
Louisiana	\$4,359.75	91.60	9.67
Maine	\$3,657.92	64.16	4.76
Maryland	\$2,608.93	54.28	4.16
Massachusetts	\$2,068.71	34.98	2.79
Mississippi	\$1,772.14	34.94	2.96
Missouri	\$378.38	9.47	0.69
Nevada	\$954.77	25.12	2.98
New Hampshire	\$2,148.70	48.39	4.04
New Jersey	\$7,946.92	139.66	11.85
New York	\$2578.06	36.30	2.79
North Carolina	\$2,742.22	60.26	6.05
North Dakota	\$48.75	0.89	0.11
Oklahoma	\$230.49	5.19	0.55
Oregon	\$85.12	1.61	0.18
Rhode Island	\$449.98	7.11	0.61
South Carolina	\$2,361.93	44.25	3.42
Texas	\$773.51	21.73	1.85
Vermont	\$2,259.03	31.54	2.55
Virginia	\$211.71	4.88	0.37
Washington	\$1,196.01	22.69	1.92
West Virginia	\$4,319.83	79.38	0.83
Wyoming	\$142.14	1.80	0.15

Sources

Column 1: Unfunded liability per capita is calculated by dividing the UAAL shown in Table 1 by the state's estimated population in 2005. Population estimates are from the U.S. Census population estimator, <http://www.census.gov/popest/states/tables/NST-EST2007-01.xls>.

Column 2: Unfunded liability as a percentage of the state's budget is calculated by dividing the UAAL shown in table 1, by the state's share of the state and local expenditures in 2005. Estimates of state and local expenditures are from <http://sourcebook.governing.com/subtopicresults.jsp?nd=695>. The estimate of the state's share of state and local expenditures is from <http://sourcebook.governing.com/subtopicresults.jsp?nd=696>.

Column 3: Annual Required Contribution, as a percentage of the state's budget is calculated by dividing the ARC shown in Table 1 by the state's share of the state and local expenditures in 2005. Estimates of state and local expenditures are from <http://sourcebook.governing.com/subtopicresults.jsp?nd=695>. The estimate of the state's share of state and local expenditures is from <http://sourcebook.governing.com/subtopicresults.jsp?nd=696>.

Hawaii with a debt of \$7,652 per person and Connecticut with \$6,224 per capita. States with the lowest per capita debt are North Dakota (\$49), Iowa (\$74), Oregon (\$85), Wyoming (\$142), Florida (\$175), Virginia (\$212), and Oklahoma (\$230).

States with the highest values of UAAL as a percent of the state budget include New Jersey (140 percent), Hawaii (115 percent), and Connecticut (107 percent). States with the lowest UAAL as a percent of their budget include North Dakota (0.9 percent), Oregon (1.6 percent), and Wyoming (118 percent). A similar ranking is observed for the ARC as a percentage of the state budget.

The significant differences in the absolute and relative magnitudes of the liabilities for retiree health plans clearly indicate that some states face major financial challenges to continue these programs in the future, while in other states the impact of retiree health on public debt is rather minor. In total, there is a large and growing unfunded liability associated with nonfederal public sector retiree health plans. In states and localities with generous plans, retiree health plans represent an expanding problem for the fiscal health of the states and cities. GASB 45 statements in these states represent a wake-up call for policymakers to consider their options for how to deal with these liabilities. However, for many other states the reality is that the GASB statements certified that they have small liabilities associated with these plans and there is no cause for alarm.

Myths, Realities, and Policies

In comparison with the private sector, state and local governments tend to provide their employees with more generous retirement benefits. Most public employees are covered by defined benefit pension plans and retiree health benefit plans. Funding rules and expectations for pension plans are clearly defined, liabilities are recognized, trust funds have been established, and state constitutions and laws limit or restrain changes in the plans that would reduce retirement benefits. In contrast, retiree health plans are a more recent employee benefit, typically no trust fund has been established, and the extent of the unfunded liabilities has only recently been recognized in conjunction with GASB 45.

Recent events have created a series of perceptions about the financial status of these plans; some are myths and some are realities. This Issue Brief has identified some of the most important perceptions concerning retiree health plans in the public sector and has shown some to be fact while others are merely myths.

based on a lack of data or understanding of key aspects of these plans.

Myth: All states face a funding crisis in their retiree health plans.

Reality: Many states face substantial future liabilities associated with these programs; however, for many other states, the unfunded liabilities are relatively small, should be easily manageable in future years, and do not require any major new policies to cope with these plans.

Myth: GASB 45 requires public sector employers to establish irrevocable trusts for their retiree health plans.

Reality: GASB standards do not require the establishment of trusts nor do they require full funding for those with such trusts. To date, relatively few states have established trust fund legislation to help finance these future costs and even fewer are making use of laws that allow funding. A more interesting public finance question is whether, in light of the GASB 45 requirements, governments should move toward full funding of their retiree health plans.

Myth: The explicit recognition of the unfunded liabilities reported in the GASB 45 statements will have an adverse impact on the bond rating of governments and investors will exert market pressure for state and local governments to begin to prefund these plans.

Reality: The key determination of whether this perception is fact or fiction depends on whether the retiree health liabilities were already known to market analysts and had previously been factored into the bond ratings. If so, one could argue that these liabilities do matter but that the GASB 45 statements do not matter because investors already were aware of them. Moody's Investors Service (2005) stated that "Moody's does not anticipate that the liability disclosures will cause immediate rating adjustments of a broad scale" and that "Moody's therefore will exclude OPEB liabilities from calculations of state or local debt burdens, but include them as a factor in the overall credit assessment of an issuer. This practice is consistent with Moody's approach to municipal pension liabilities." The reality of the impact of GASB 45 statements will become more apparent in the next few years.

Myth: Retirement benefits are protected by state laws and provisions in their constitutions.

Reality: In general, no such protection exists for retiree health plans and public sector employers have been constantly making changes to these plans that reduce the generosity of the benefits and raise the cost to retirees. The expectation is that public sector employers will continue to amend their plans in ways that reduce costs. However, political realities limit the ability of government to reduce compensation for public sector employees and promised benefits to retirees.

Several other important issues remain concerning public perceptions of the cost and liabilities of retiree health plans. GASB 45 requires an assessment and acknowledgement of the cost and accrued liabilities associated with retiree health plans using approved accounting standards. Estimates of the annual required contributions and the unfunded actuarial accrued liabilities provide an important benchmark for evaluating these plans and determining future policy decisions. One should keep in mind that these are estimates of future costs. Obviously, future projections can be altered by amending the plans or by future national health insurance initiatives. The projections will be much higher if medical inflation does not decline as assumed in the reports and pre-funding would alter the need for new tax monies to be devoted to these plans.

These substantial liabilities pose a serious financial problem for many states and municipalities. These unfunded liabilities will confront policymakers with difficult choices in the future. In 2006, the annual cost to state and local governments for retiree health plans averaged about 2 percent of employee salaries. If public sector employers continue to pay for these benefits on a pay-as-you-go basis, the cost of retiree health plans is projected to rise to 5 percent of payroll in 2050 (GAO, 2008).

As the annual cost rises, the ability to finance these programs may cause other priorities to go unmet, and the overhang of billion dollar retiree health insurance liabilities may influence future bond ratings. There are a number of options that states can adopt to address the impending financial burden. The choices are clear for state and local governments that have large liabilities. Governments can either increase total revenues to support the current programs, shift funds from other priorities to finance retiree health plans, or reduce benefits associated with these programs. A future Issue Brief will examine policy options and their impact on the cost and liabilities of retiree health plans.

In response to GASB 45 and the financial pressures associated with retiree health plans, states and local

governments are considering many policy responses. For some governmental units, the unfunded liabilities and the annual cost of retiree health plans are very large and threaten their financial stability. These public employers are likely to focus on reducing the future cost of their retiree health plans even as they struggle to pay for the promises made to current workers and retirees. States and municipalities with less generous benefits are under much less fiscal pressure. Understanding the realities of the current financial status of individual plans is a key to developing new policies. We should expect that these policies will vary across governmental units and that they will reflect the substantial differences in the generosity of today's plans and the accompanying liabilities.

References

- California Legislative Analyst's Office. 2007. "Retiree Health Care: A Growing Cost For Government." http://192.234.23.2/2006/ret_hlthcare/retiree_health_care_021706.htm
- Federal Reserve Bank of Boston. 2007. "GASB 45 and other post-employment benefit promises: The fog is clearing." *Policy Brief* written by Steffanie Brady, September.
- Goldman Sachs. 2007. *The Trillion Dollar Question: What is your GASB 45 number?* New York: Goldman Sachs.
- Government Accounting Standards Board. 2004. Statement No. 43. *Financial Reporting for Post-employment Benefit Plans Other than Pension Plans*. www.gasb.org/st/summary/gstm43.html
- Government Accounting Standards Board. 2004. Statement No. 45. *Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions (OPEB)*. <http://www.gasb.org/st/index.html>
- Kaiser Family Foundation and Health Research and Educational Trust. 2006. *Employer Health Benefit 2006 Summary of Findings*.
- Moody's Investors Service. July 2005. *Other Post-Employment Benefits (OPEB): New Accounting Requirements to Shed Light on Cost of State and Local Retiree Health Benefits Funding Pressures Expected to Vary Widely*.
- Pew Center on the States. 2007. *Promises with a Price: Public Sector Retirement Benefits*. Pew Charitable Trusts.
- Sanzillo, Thomas. January 2007. "Testimony From First Deputy Comptroller Thomas Sanzillo Regarding GASB 45 Accounting Change." *News From the Office of the New York State Comptroller*.
- Standard & Poor's. November 2007a. *Commentary Report: OPEB Obligation Bond Funding Strategies Offer Risks and Rewards*. New York: Standard & Poor's.
- Standard & Poor's. November 2007b. *U.S. States Are Quantifying OPEB Liabilities and Developing Funding Strategies As the GASB Deadline Nears*. New York: Standards & Poor's.

U.S. General Accounting Office. 2007. *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs*. GAO-07-156. September.

U.S. General Accounting Office. 2008. *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits*. GAO-08-223. January.

Vicente, Thomas. 2006. *Public Sector Employers Must Change Accounting for Retiree Health and Other Postemployment Benefits*. Aon Consulting Research Brief, July.

Wisniewski, Stan and Lorel Wisniewski. *State Government Retiree Health Benefits: Current Status and Potential Impact of New Accounting Standards*. Washington: AARP.

Zion, David and Amit Varshney. March 22, 2007. *You Dropped a Bomb on Me*. GASB. Credit Suisse.

Endnotes

- 1 There has been some disagreement about plan coverage of several states in previous studies. Credit Suisse (Zion and Varshney, 2007) reports that all states except Mississippi, Nebraska, and Wisconsin provide some type of retiree health insurance. Wisniewski and Wisniewski (2004) state that all 50 states offer health benefits to their retirees under the age of 65, and all but Indiana and Nebraska offered health insurance to retirees age 65 and older. In our survey of state finance and health care administrative leaders, representatives of four states responded that they did not have a retiree health benefit program. Such disagreements arise due to the diversity in retiree health benefit plans and the respondents' views of what constitutes a plan.
- 2 Typically, the "full cost" of a retiree health plan paid by retirees would be the average cost of all participants in the health plan for active workers and retirees. Due to age-related differences in the cost of health insurance, allowing retirees to pay the same premium for participating in the plan involves an implicit subsidy. The new GASB standards require measurement and reporting of this subsidy to retirees.
- 3 GASB Statement 45, *Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions (OPEB)* was issued by the Governmental Accounting Standards Board in 2004. Basically, GASB 45 requires public employers to account for the cost of retiree health plans using the same methods used to estimate the liabilities associated with pensions. The complete standard can be seen at <http://www.gasb.org/st/summary/gstm45.html>. Earlier in 2004, GASB issued Statement No. 43, *Financial Reporting for Post-employment Benefit Plans Other than Pension Plans*. GASB 43 sought to establish uniform reporting standards for retiree health plans.
- 4 Vicente (2006) provides a useful explanation of the new accounting standards and a summary of the issues raised by GASB 45.
- 5 The aging of the U.S. population is typically reflected in the aging of the populations of the various states. As a result, the costs of retiree health plans are expected to rise due to increasing numbers of retirees. Mortality improvements result in more

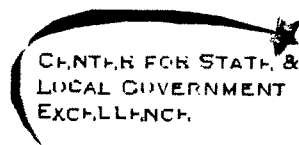
years in retirement and thus increase the cost of providing retiree health insurance.

6 Opinions vary on the number of states that have actually established such funds. Standard & Poor's (2007b) reports that Alabama, Georgia, Kentucky, Maryland, Massachusetts, Ohio, South Carolina, Utah, Vermont, and West Virginia had established trust funds for their retiree health programs. Other studies have presented different lists for states that have engaged in some prefunding. For example, Wisniewski and Wisniewski (2004) in a report prepared for AARP concluded that 11 states were using some type of prefunding in 2003. Their list included eight states that are not included in the S&P list shown in the text. The Pew (2007) report finds a different

set of states with some type of funding, including several states that are moving toward fully funding these obligations. Ohio appears to have the largest trust fund assets of about \$12 billion (Standard & Poor's, 2007b). Of course, enacting legislation to establish authorization for a trust fund does not imply a commitment to actually prefund retiree health obligations.

7 For example, North Carolina has extended the years of service required to be fully vested in its RHI plan from five years to 20.

8 Studies that have estimated the UAAL and ARC for state retiree health plans include Goldman Sachs (2007), Pew (2007), Standard & Poor's (2007b), Wisniewski and Wisniewski (2004), and Zion and Varshney (2007). Also see GAO (2007).



Board Of Directors

Jan McCallen

President and Chief Executive Officer, ICMA Retirement Corporation

Robert J. O'Neill

Executive Director, ICMA

The Honorable J. Kenneth Blackwell

Ronald Reagan Distinguished Fellow, The Buckeye Institute for Public Policy Solutions;
former mayor, Cincinnati; secretary of state, Ohio

Donald J. Borut

Executive Director, National League of Cities

Gregory J. Dyson

Senior Vice President of Marketing, ICMA Retirement Corporation

Jeffrey L. Esser

Executive Director, Government Finance Officers Association

Peter A. Harkness

Editor and Publisher, Governing Magazine

Feather O'Connor Houstoun

President, William Penn Foundation; former secretary, Pennsylvania Department of Public Welfare

George V. Pedraza

Director, UBS Securities, LLC; Chief Executive Officer, Academica Management SW, LLC

Raymond Scheppach, PhD

Executive Director, National Governors Association

The Honorable Anthony A. Williams

Chief Executive Officer, Primum Public Realty Trust; former mayor, District of Columbia

SLGE Staff

Elizabeth K. Keller

Executive Director

Joshua M. Franzel, PhD

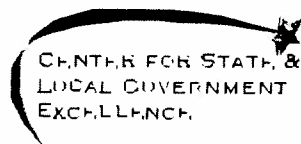
Research Associate

Amy M. Mayers

Communications Manager

Bonnie J. Faulk

Program Assistant



Helping state and local governments become
knowledgeable and competitive employers

About the Center for State and Local Government Excellence

The Center for State and Local Government Excellence helps state and local governments become knowledgeable and competitive employers so they can attract and retain a talented and committed workforce. The Center identifies best practices and conducts research on competitive employment practices, workforce development, pensions, retiree health security, and financial planning. The Center also brings state and local leaders together with respected researchers and features the latest demographic data on the aging work force, research studies, and news on health care, recruitment, and succession planning on its web site, www.slgc.org.

The Center's five research priorities are:

- Retirement plans and savings
- Retiree health care
- Financial education for employees
- Talent strategies and innovative employment practices
- Workforce development

777 N. Capitol Street NE | Suite 500 | Washington DC 20002-4201 | 202 682 6100 | info@slgc.org